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Chairman King, Ranking Member Maloney and distinguished members of the House Financial Services Subcommittee, thank you for inviting me to testify about the financial services provisions of recent trade agreements and, in particular, the Free Trade Agreements (FTAs) with Chile and Singapore. I will also discuss the investment and capital transfer provisions in these FTAs and how they relate to the successful 20-year program bilateral investment treaties (BITs) that guarantee the free movement of investment-related capital across borders.

Financial Services Provisions in the Chile and Singapore FTAs

Strong financial services rules and commitments are an essential component of any comprehensive trade agreement. Reducing barriers to trade in financial services is a necessary part of meaningful economic integration. Recent studies have shown that countries with an open and well-supervised financial services sector experience substantially increased growth rates. Downstream sectors that consume those services benefit from their enhanced efficiency. And a strong financial sector increases both the amount of national savings and the efficiency of its allocation.

Our trade agreements have traditionally contained separate provisions on financial services. The FTAs with Chile and Singapore are no exception. The FTA provisions on financial services:

1. Secure the right to invest and to establish financial institutions in our FTA partners' territory and ensure that our FTA partners do not apply measures that discriminate against U.S. financial institutions, investors and investment in financial institutions, or cross-border financial service suppliers as compared to domestic or other foreign counterparts.

2. Secure rights with regard to expropriation and the transfer of capital and investment returns as well as the right to resolve disputes with a host government through binding international arbitration for these obligations.

3. Provide exceptions for prudential measures and for monetary and exchange rate policy in order to provide the regulatory flexibility required by financial regulators. (Regulators'

concerns about dispute resolution procedures are addressed by provisions that encourage or require the use of financial experts, particularly in cases involving prudential measures.)

These provisions apply to all types of investment in financial services unless an FTA partner identifies and negotiates exceptions called "non-conforming measures."

In the case of the Singapore FTA, we were able to achieve significant liberalization in areas where markets were not previously open or were not sufficiently transparent. For instance, Singapore has agreed to substantial new access for U.S. banks to Singaporean customers. Within 18 months of entry into force of the agreement, it will lift its ban on new licenses for banks authorized to provide the broadest range of services, and it will lift its ban on wholesale banks 18 months later. It will end discriminatory restrictions on the number of customer locations two years after entry into force of the agreement and will allow our banks to negotiate access to ATM networks run by locally owned banks.

Chile does not currently have major restrictions of this nature, but it too will implement some changes. For instance, it has agreed to adopt changes to its financial services regime to provide for prior notification and comment on new regulations. Moreover, Chile will not apply its economic needs test to U.S. financial institutions managing assets under its mandatory pension system.

The FTAs we have negotiated with Chile and Singapore provide financial service suppliers the opportunity to compete in these markets, providing benefits to people in Chile, Singapore and the United States.

Investment and Capital Transfer Provisions: Some History

The investment chapters of the Chile and Singapore FTAs provide for the free transfer of funds related to an investment into and out of each country. These provisions reflect a continuation of the United States' long-standing policy of assuring that investment flows may move unimpeded by controls. Therefore, before describing the details of the investment and capital transfer provisions contained in the Chile and Singapore FTAs, I would like to review the history and basis for this policy.

Foreign investment is vital to economic growth around the globe. In the case of the United States, annual flows of U.S. direct investment abroad increased from an average of $28 billion between 1983-91 to $91 billion between 1992-2002. On average, the sales of U.S. affiliates abroad exceed $2.2 trillion annually; these sales help support jobs and business activities in the United States. In total, about two-thirds of all U.S. exports since 1989 were made by U.S. companies with investments overseas. Foreign investment *into* the United States also provides a host of economic and social benefits. Like domestic investment, foreign direct investment in the United States creates good jobs, increases productivity, and raises U.S. living standards. It also strengthens U.S. firms and makes them more competitive in the global economy.

Foreign investment is also a principal means to spur economic growth and development in poorer countries. It can provide the financial, technical, and managerial resources to expand economic potential in these countries. FDI can act as an engine for economic development by bringing in new technology and management practices, and by setting standards for local suppliers, thereby making those suppliers more competitive at home and abroad.

There are several ways the Administration is seeking to help developing countries attract investment. Most recently, we are working very hard to push forward the President's Millennium Challenge Account. The MCA will allocate development assistance to those countries that are committed to the adoption of sound policies. The strong incentive provided by the MCA is intended to spur countries to improve contract enforcement, the independence of the judiciary, and the security of property rights. Only those countries that are pursuing responsible monetary and fiscal policies, removing the barriers to business formation, and investing for a healthier and more educated work force will be rewarded. The key point here is that the MCA will make those countries more attractive to investors.

The bilateral investment treaty program, which started in the early 1980s, is another way of encouraging private sector investment flows to developing countries. The existence of a U.S. investment agreement can affect the location decisions of U.S. companies. Surveys of U.S. companies with investments in developing and emerging market countries indicate that U.S. companies factor political or non-commercial risk into their investment decisions. One of the most important elements they consider is whether there is an environment based on the rule of law. U.S. investment treaties are intended to foster the rule of law and lower political risk by, among other things, obligating countries to honor contracts, encourage economic and regulatory reforms, and agree to international arbitration as an alternative to biased or corrupt court systems.

The United States now has over forty Bilateral Investment Treaties (BITs) with other countries. U.S. investment agreements facilitate investment by assuring investors, among other things, six basic rights:

1. The fundamental right to transfer capital and investment returns freely into and out of a country without delay and at a market rate of exchange.

2. Both pre- and post-establishment rights to the better of national or most-favored-nation (MFN) treatment.

3. Limits on the ability of a government to impose inefficient and trade-distorting performance requirements such as local content and export requirements.

4. Protection against expropriation of an investment that is not in accordance with customary international law standards.

5. Right to resolve disputes with a host government through binding international arbitration as an alternative to domestic courts.

6. Right to employ top managerial personnel of their choice, regardless of nationality.

The first of these rights—free transfers of capital and investment-related returns—is a mainstay of U.S. international investment agreements. It has weathered some twenty years of change in the economic and political climate and held fast through Republican and Democratic Administrations. The right of free transfers is considered by the business community as one of the most important protections conferred in these treaties.

Protection of free transfers is also a key part of a sound investment climate, which is particularly important for emerging markets and developing countries. In a world where countries must compete for scarce international capital, countries that offer investors a high-quality investment climate will be more successful in attracting investment—investment that is needed to create jobs, raise productivity, and increase living standards. Conversely, restrictions on capital flows serve to discourage investment.

Despite the long history of protecting the right of free transfers, some have contended that the Asian financial crisis showed the need for limits on the free movement of capital. They argue that restrictions on capital flows into developing and emerging market economies are needed in times of financial crisis. I disagree strongly with this view for several reasons.

First, I know of no conclusive evidence that capital controls have corrected an economic crisis. To the contrary, such controls have negative economic consequences. Capital controls weaken investor confidence and can reduce inflows of foreign investment. Indeed, foreign direct investment in Malaysia fell after imposition of controls even though the controls did not apply to FDI.

Second, capital controls involve significant administrative costs. Governments that impose controls must administer them through strong regulation and enforcement because controls create circumvention incentives. Countries are often forced to pass new legislation to address the circumvention of capital controls. Maintaining capital flow restrictions is a difficult, expensive, and often futile task. For countries in the world that are already battling cronyism, the imposition of capital controls offers another avenue for rent-seeking behavior.

Third, capital controls artificially reduce the pressure for countries to institute needed economic reforms. Capital controls tend to forestall the execution of difficult reforms that are needed to build the foundation for economic growth and rising living standards.

Fourth, capital controls increase the risk to the domestic economy in a time of crisis. Capital controls prevent domestic investors from diversifying into international markets, with the consequence that any shock to the domestic economy is amplified. In addition, capital controls on inflows limit sources of credit and investment for domestic companies, which is particularly problematic in a period of crisis. If domestic credit markets dry up because of a shock, the inability of domestic industries to tap foreign investment flows will subject them to additional pressures resulting from the ensuing credit crunch.

Some proponents of capital controls argue that requiring governments not to interfere with capital movements is an infringement on national sovereignty. But ensuring free capital transfers does not imply that host countries forfeit their sovereign right to pursue domestic economic policies. The host country continues to have the ability to pursue other adjustment mechanisms that are consistent with free transfers, such as monetary policy (which effects changes in international reserves, interest rates, and exchange rates) and fiscal policy.

Investment and Capital Transfer Provisions in the Chile and Singapore FTAs

In the negotiations of the Chile and Singapore FTAs, all sides agreed on the importance of free transfers and avoiding capital controls. The investment chapters of the Chile and Singapore FTAs provide for the free transfer of funds related to an investment into and out of each country. The flows covered by this provision include foreign direct investment, profits, dividends, the proceeds from the sale of an investment, and payments for loans or bonds issued in a foreign market.

The Chile and Singapore FTAs contain a special dispute settlement mechanism that would apply in the event that Chile or Singapore takes measures to restrict the transfer of capital. Under this mechanism, U.S. investors cannot file claims for violations of the free transfers obligation for up to one year on certain capital flows, provided the restrictions do not "substantially impede transfers." If the restrictions are lifted within a year, the affected investor will not have recourse to dispute settlement on these restrictions. If the restrictions are in place for more than a year, the investor may take a claim to dispute settlement, and may seek damages caused by the controls after their first year in operation. Investors will have the burden to prove the existence and extent of damages caused by the controls. The cooling-off period for other issues before a claim may be taken to dispute resolution is six months.

These new provisions are found in an annex to the investment chapters of the FTAs. Whether these provisions are appropriate for other countries will be determined on a case-by-case basis.

The free transfer provisions of the Chile and Singapore FTAs meet an important Trade Promotion Authority (TPA) objective – "freeing the transfer of funds related to investments." These provisions provide U.S. investors with substantially strengthened transfer rights over those available under the IMF Articles of Agreement and the General Agreement on Trade in Services (GATS). These agreements, like most multilateral agreements, represent a floor for investor protection. Our position is to seek greater protection for U.S. investors than the IMF Articles of Agreement and the GATS afford. In addition, unlike those other agreements, the FTAs provide for effective investor-state arbitration provisions to enforce free transfer rights.

The approach undertaken in these FTAs is consistent with the shared economic philosophy and policy perspective of the United States, Chile, and Singapore. The inclusion of the free transfer provision in the Chile and Singapore FTAs with the United States sends a strong signal to the markets that all three countries support the free flow of capital and recognize its importance in the development of an economy. Without a doubt, these agreements represent a win-win situation for all involved countries.

I wish to thank the Subcommittee for this valuable opportunity to discuss the Administration's trade in financial services and international investment policies.